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EDITORIAL

Retail: Is CVA the Only Answer?

Sarah Rayment, Partner, BDO UK LLP, London, UK

Background – what is a CVA?

A Company Voluntary Arrangement ('CVA') is a procedure under Part 1 of the Insolvency Act 1986 which enables a company to enter into a legally binding agreement with its unsecured creditors to compromise amounts owed to them. The company does not have to be insolvent or unable to pay its debts in order to propose a CVA. It is a flexible procedure with limited Court involvement and does not affect the rights of secured creditors. It is a contract between a company and its unsecured creditors.

A CVA is a collective procedure in Annex A to the EC Insolvency Regulations and as such can be proposed by a company regardless of where it is incorporated provided it can be demonstrated that the COMI is in the UK.

A CVA may be proposed by the directors, an Administrator or Liquidator of a company. If proposed by directors it is their proposal. They may be assisted in drafting it to ensure it complies with the legislation and best practice usually by an Insolvency Practitioner and legal advisors. The directors will also request an insolvency practitioner act as Nominee. The Nominee should be satisfied that the proposal it is achievable and that there is a fair balance is between the interests of the company and the creditors. They are required to provide a report to the company's shareholders and creditors which provides sufficient information to enable the stakeholder to make informed decisions in relation to the proposal and the CVA. This report is also filed in Court. The report will state whether or not, 1) the company's financial position is materially different from that contained in the proposal 2) the CVA is manifestly unfair and 3) the CVA has a reasonable prospect of being approved and implemented. The Nominee will summon the meetings of shareholders and creditors. The Nominee will normally act as Supervisor of the implementation of the proposal if the CVA is approved.

A CVA requires the approval of 50% in value of shareholders and 75% in value of those unsecured creditors who vote either in person or by proxy. A second vote is held at which only unconnected unsecured creditors votes are counted. The CVA is approved if at this second vote, less than 50% of the unconnected unsecured creditors vote against it.

It will be binding on unsecured creditors even if they did not vote because they did not receive notice. However, following approval, a CVA may be challenged by a creditor by application to Court within 28 days of approval on the basis of either:

– a material irregularity at the creditors' or shareholders' meeting; or
– the CVA unfairly prejudices the interest of a creditor.

The Court will assess whether the CVA is unfairly prejudicial by considering the following:

Vertical comparison

– This is the assessment of the creditor's position in the CVA against their outcome in an insolvent liquidation.

Horizontal comparison

– This considers the position of the creditor against other unsecured creditors in the same class. The test will assess fairness and whether the creditor has been properly compensated.
– The fact that similar creditors such as landlords may be categorised differently does not mean the creditor is being unfairly prejudiced. If the CVA offers the appropriate level of compensation for the prejudice suffered by the creditor then an unfairness challenge is unlikely to succeed.

Popular application

The use of the procedure is popular with businesses with large leasehold estate portfolios such as in the retail and casual dining sectors. The procedure enables a company to put forward a proposal whereby rents are reduced to market rent and non-performing units are exited with the lease liabilities being compromised. If the CVA is approved the Landlord can be prevented from taking recovery action.

There has been a rise in high profile CVAs in the retail and casual dining sectors in the UK over the past few years as a result of decline in performance in both sectors. There are a number of factors contributing to this decline notably the transition away from bricks and

mortar to online shopping in retail together with over expansion coupled with expensive estate and fit outs in both sectors. In addition all UK businesses have had to absorb several increases in employment costs and property tax increases. Unforeseen external events including Brexit and the effect on consumer confidence has also been sighted as reasons for the decline in these sectors.

How successful CVAs really are has become the topic of debate over more recent months where analysis has shown that many companies have subsequently fallen into Administration. This article will look at what is required for successful CVA and will consider whether a pre-pack administration sale may in some cases be more appropriate.

Why CVA?

CVAs are attractive for a number of reasons the primary one being that the control of the company remains with the directors. The process allows the directors to put forward proposals to the unsecured creditors together with sufficient information to enable those creditors to determine whether they wish to vote in favour and support the proposal and effectively the business going forward. A CVA is generally less expensive and disruptive to a business than an Administration and less impactive on value and liquidity.

The flexibility of a CVA allows a business to be restructured and may include the injection of new equity or debt or a restructuring of existing facilities conditional upon the approval of the proposals. The process can provide the platform for reshaping staffing including management and to change contractual terms so long as the fairness test can be satisfied.

The CVA procedure is more popular in retail situations than Schemes of Arrangement under Part 26 of the Companies Act 2006, (Scheme), as all unsecured creditors are treated as the same class for voting purposes. In a Scheme where creditors are being treated differently they are allocated into classes. The Scheme is approved at meetings of *each* class of creditor and members. This is one of the fundamental differences with a CVA and the main reason why the procedure is not as popular as a CVA.

CVA and their impact on creditors

The group of creditors that are often cited as being the ones to lose out in a CVA a business with a leasehold estate are the landlords. All unsecured creditors are entitled to vote regardless as to whether their debt is being compromised. It is not unusual for none of the trade creditors to be compromised. Leasehold assets tend to be categorised in to three groups depending on their trading performance; current market rental value and relevance to the business going forward:

– Group 1 – performing units where no compromise of lease terms is proposed.
– Group 2 – It has become standard practice to subdivide this group seeking different % of reduction of rent in each group. The rent reduction sought may be in the order of 80%, 60% or 40%
– Group 3 – unit closures or a 100% reduction of rent with only rates and other property outgoings being paid.

When putting forward a proposal where claims are compromised as set out above the Nominee needs to balance the interests of the creditors and the company.

Why do they fail?

If they are so flexible why do they fail? Perhaps the question should be what makes a successful CVA? For a CVA to be successful the ingredients are simple an underlying viable business, a committed management team and a deliverable robust funded business plan. In addition to this early engagement with certain stakeholders is key. The timing of engagement will differ dependant on the stakeholder as discussed below:

Secured Creditors – The rights of secured creditors cannot be varied by a CVA. However, the proposing a CVA will invariably constitute a breach under the terms of any facility agreement. Therefore engagement should take place before the proposals are finalised and launched. They should state whether the Secured Creditor(s) are supportive and whether they will provide facilities going forward. The business plan may require a restructure of terms including write down of debt or conversion to equity this will take time to negotiate. Where possible the timetable should include sufficient time to allow for proper engagement and agreement of terms

Landlords – Engagement with landlords will normally take place immediately following launch of the proposal ie when it is sent out to creditors. In advance of individual landlord meetings it is good practice to consult with the British Property Federation, (BPF), on the keys terms of the proposal and specifically the categorisation of landlords. The BPF is a UK organisation that represents and promotes the interests of property businesses with an interest in the UK including many landlords.

Some landlords have expressed concern that the CVA is being used as a process to cram down their rights with no other stakeholders sharing the pain. Through the BPF these landlords have found a platform through which to voice these concerns.

Key Suppliers – Engagement would typically take place following launch of the CVA proposal to provide sufficient clarification of the terms and seek continued support between launch and approval. During this

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period is when a business is most likely to experience liquidity issues.

Returning to the question of why a CVA will fail we examine the main reasons for failure below:

– The wrong management team

  The directors that proposed the CVA may not be the right people to drive and turn around a business facing distress. Having the right team with the appropriate skills and who are properly incentivised is key to delivering a successful CVA.

– Lack of a robust turnaround business plan and funding

  Fundamental to success is a clear plan for delivering a sustainable profitable business going forward supported by realistic trading forecasts. A number of CVAs have failed as a result of overly optimistic business plans and not being able to raise funding following approval. It is the role of the Nominee to challenge the plan. The Nominee's report must state whether he believes that the CVA has a reasonable prospect of succeeding to do so he needs to be satisfied that the plan is achievable and deliverable.

  The plan should not all be about cutting cost. It should demonstrate how operational and efficiencies will be delivered and how this will have a positive impact on the business.

– Loss of supplier support

  Whilst creditors may be bound in terms of their historic debt and have to accept amendments to contractual terms but they do not necessarily have to continue to trade with the company going forward.

– Loss of key staff

  Retaining key staff can be challenging. Many will leave unless appropriately incentivised.

The alternative to CVA

The most popular alternative to the CVA has been for many years an administration with a sale of the business and assets being negotiated in advance of the company going into administration and completed immediately thereafter. There are a number of benefits to what is called a pre-pack sale. They generally protect value and therefore the returns to creditors of an insolvent company. They help to rescue the underlying business and to save jobs.

The purchaser acquires only the parts of the business that they require going forward. In a business with a large leasehold estate the least profitable units are left behind for the administrator to deal with. The purchaser will occupy under a licence granted by the administrator and will seek an assignment of the lease with the landlord. They may take this as an opportunity to negotiate more favourable terms than the company in administration was bound by. The landlord will be under no obligation to renegotiate but may determine that continuity of occupation is more favourable than an unoccupied premises and the cost of holding an empty property.

The business will more commonly be acquired in a new spv and will therefore have a clean balance sheet. Only certain contracts will transfer namely those of the employees in the acquired stores and in some cases head office employees. The contracts of employment of employees of the closed stores will not usually have been deemed to have transferred.

Pre-pack sales have received a certain amount of negative press in the UK due to the fact that they are seen as a mechanism by which existing management can acquire the business and leave behind creditors. The Pre-pack Pool (Pool) was launched in November 2015 following the Graham Review which was commissioned by the UK Government due to concerns about transparency of sales particularly to connected parties. The Pool is a group of experienced business people who provide an opinion on a proposed sale. On a voluntary basis connected parties seeking to acquire a business by way of a pre-pack approach the Pool. The opinion of the Pool is then made available to creditors as part of the Administrators first communication following appointment in what is known as a SIP 16 disclosure. Copies of all Sip 16 disclosures are sent to the Administrator's regulatory body. Whilst the use of the Pool is not compulsory a record of Pre-pack sales is being maintained by the disclosure of the SIP16 reports. SIP 16 is a statement of best practice for the conduct of Pre-pack sales by insolvency practitioners. The introduction of both the Pre-pack Pool and a revised SIP 16 has regularised the way in which pre-pack sales have been conducted and are welcome introductions. A pre-pack will in many cases represent the best outcome creditors.

Between 1 November 2015 and 31 December 2016 there were 1,689 Administrations with 371 pre-pack sales. Of these just over half were to connected parties in the remaining cases the business will have been sold to new management who will not be tainted with the legacy of the previous failure.

In conclusion both procedures have their place in the restructuring landscape but each case needs to be assessed on the prevailing circumstances. Administration can be used in most cases whereas a CVA will only be suitable in certain circumstances.

There are proposals being considered by the European Parliament in respect of restructuring and insolvency which include the adaption of insolvency procedures to enable companies in financial difficulties to restructure early, akin to the US Chapter 11 model of debtor in possession. These include removing the

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requirement to file for insolvency where the company is in the process of restructuring and where the filing might prevent the restructuring from being achieved. It will be interesting to see whether these proposals are developed further and if so the impact on CVAs, Schemes and Pre-Pack Sales.

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International Corporate Rescue

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